Blackwall Capital

European Equity Long-Only

Quarterly Newsletter
Q3 2019

Blackwall Europe Equity Fund

Quarter to Date Return: – 3.10%*
Year to Date Return: 0.10%*
Assets Under Management: EUR 16.7m*

Dear Investor,

The Blackwall Europe Equity Fund ended Q3 at –3.10%.

Market developments throughout Q3-2019 have been more challenging than they appear at first glance. While indices were virtually unchanged over the quarter, the period proved to be quite volatile. After a stable month of July, equities faced a significant setback in early August, which was reversed in September. However, this was only a small part of the story. The bigger story is that market internals (the components that make up an index) have shown an increasingly small number of heavily-weighted large and mega-caps (e.g. Nestle, SAP) providing most of the index returns. Significantly, many small and mid-cap stocks continued to decline. Additionally, there has been a substantial sector rotation taking place, resulting in underperformance of actively managed equity funds relative to passive competitors.

1) Economic fundamentals and politics

During Q3-2019 we saw further weakening of the global economic landscape reflected in ongoing deterioration of key forward-looking macro data such as PMIs. At the same time, hard economic data, including order intake and exports showed temporary signs of stabilization throughout July and August, before continuing their descent again in September 2019.

On the political front, trade tensions between the US and China increased further after China retaliated with the imposition of additional tariffs on US imports. Positive investor sentiment completely reversed on August 1, after the US increased tariffs on China yet again when it became apparent that no trade deal was in sight.

Throughout Q3-2019, tensions entered a new dimension when the Chinese currency fell below the long-established hurdle rate of 7 yuan to the dollar and currency markets also began to face turmoil. However, due to the White House talking up the likelihood of a "China trade deal soon", not convincing to us, sentiment and equity indices recovered in the final month of the quarter.

2) Q2-2019 European reporting season

The Q2-2019 reporting season finished with European earnings down -4.5% YoY following on from a decline of -5.1% for Q1-2019 (Source: Morgan Stanley), confirming the manufacturing sector-induced earnings recession in Europe. Even the previously lowered market expectations were decisively missed and further downward revisions of earnings estimates followed. What remained (to our surprise given the continued decline of lead indicators and ongoing profit warnings), was investors' hope of a turnaround in the coming 3-6 months.

With Q3-2019 now ended and adverse pre-announcements/profit warnings already started a fortnight earlier than in preceding quarters, that hope looks ill placed. In light of recent anecdotal

*Source: Northern Trust as per latest month end. The figures refer to the past. Past performance is not a guide to future performance. Performance is quoted net of fees based on unaudited figures for the current year. Performance is calculated using NAV figures (Class I EUR) rounded to two decimal places. Launch date: 13 December 2018.

evidence from the corporate world, talking down again expectations or even initiating capacity reduction/restructuring efforts, we remain convinced that the final quarter of 2019 will not save the year.

As a result, we held on to our cautious positioning throughout the entire Q3-2019. That bias cost us performance for the quarter, but what has proven even more detrimental to the fund's quarterly result has been the market's abrupt sector rotation from defensives into beaten-down cyclicals in the middle of September. We did not anticipate such a move as fundamentals did not even indicate a bottom-building process and US leading indicators had only begun to decline. Calling for "the last" profit warning and a reversal at this stage of the cycle looks completely wrong to us. Indeed, the rotation into cyclicals has proven short-lived (taking into account the market's reversal in early October), but it was enough to explain for a good part the lagging performance in Q3-2019.

3) Idiosyncratic investment issue

As we explained in our August 2019 monthly comment, our portfolio was also affected by an adverse idiosyncratic event: the profit warning of Voltabox. The company announced with Q2-2019 results a harsh cut in full 2019 growth and earnings expectations, which sent the share price down by more than 50%. The warning was caused by a) the one-quarter postponement of a US 5G telecoms back-up battery order and b) the delayed product transition of a key supplier. While both issues emanated from outside Voltabox' control, their massive impact on the company's results shows a clear deficit in terms of execution. However, the company has not lost any customer contracts, its massive order backlog is still unchanged, and measures to cut expenses and re-focusing of operations have been immediately initiated. The market's punishing of Voltabox shares reflects the company's strong cash burn in recent six quarters as well as its unfavorable communication with the financial community. Both matters have also been addressed: Voltabox has implemented specific measures to free up capital from working capital and to reach a positive free cash flow for H2-2019, though not fully compensating for the EUR24m H1-2019 cash burn. In addition, the company indicated its CEO and new CFO will more actively and transparently communicate with the markets to prevent any similar mis-communications from happening again.

We are prepared to give Voltabox the benefit of the doubt and took advantage of the depressed valuation. We believe the company's cash burn should reverse into free cash flow generation from Q3-2019 - assuming Voltabox will execute without further issues going forward, thereby delivering substantial top-line growth and a return to healthy EBIT from 2020. With the original investment case shifted back by 6-12 months and most investors having lost patience, there is room for a positive surprise.

Corticeira-Amorim

In this quarter's newsletter we wish to present another of our conviction investments, the shares of Portuguese Corticeira Amorim (CA). CA is a EUR1.3bn market cap, 71% family-held, world-leading quality niche business supplying the global wine and spirits industry with cork stoppers. The mission of CA is to "add value to cork (o/w >80% globally is harvested in Iberia) in a competitive, distinctive and innovative way that is in perfect harmony with nature". The vertically integrated, very well run (top quality management, in our view) company serves over 27k customers worldwide. Market leader CA holds an estimated world market share of c. 40% in cork stoppers and thus enjoys a scale advantage, innovation leadership, and robust pricing power. It is protected by very high entry barriers and rooted on conservative accounting as well as robust financials (Net debt/EBITDA c. 1.0x - after-tax RoIC 11-17%). CA is the only vendor with a full range of stoppers (70%) as well as adjacent industrial products (30%) in Floor & Wall Covering, Cork Composites and Insulation, with the latter three combined gradually gaining in relevance.

We project CA to achieve a sustainable like-for-like top-line growth of c. +3-4% (1-2% pts above market) for the coming three years, with the main limitation being the availability of cork. That yoy growth rate should be driven by wine, sparkling wine and spirit production growth (c. 0.3-1.0% pa), the gradually expanding penetration of cork stoppers (from approximately two thirds today) at the expense of glass and synthetic stoppers thanks to consumers' preference for cork stoppers, and the increase in geographical reach/penetration (Americas, Asia). On top come steady market share gains at the expense of much smaller, less efficient, rather local competitors and selective M&A. In recent years, CA has been actively consolidating the market, completing 1-2 bolt-on acquisitions p.a. at very attractive multiples, and thereby reinforced the group's position e.g. in speciality segments such as bar top closures for spirits.

With the raw material cork standing for 70% of the group's COGS, cork input prices are of outmost importance. Raw cork pricing mostly depends on the quantity of the annual harvest, with every cork tree only able to be harvested once every nine to ten years. Due to the low harvest in 2017 particularly in 2018, cork prices shot up in recent years, with CA compensating for the adverse impact only partially with price hikes. Thanks to the gradual reversal of cork prices from late 2018 (being down c. 5-7% to date) and the highest cost primary cork fully consumed by autumn 2019, the group's operating return is about to bottom out. Against the background of a better, higher quantity harvest seen for 2019 and anticipated also for 2020 and 2021, a margin recovery from this year's EBITDA trough at 16% (and EBIT at 12%) appears likely to materialize for the three years to come. That implies, EBITDA is very likely to expand by c. 35-40% from 2019 through 2022, resulting in a 2022 EBITDA margin of 20% and a boost in EPS of roundabout 60% for the same period 2019-22.

Hence, we see CA shares as a safe means to capture sustained EPS growth of 15-20% p.a. for the coming three years. Due to the shares yet undiscovered and under-owned, we have been able to build our position at attractive entry level (below 10x trough EBITDA 2019E). Thereby, the potential risk of US trade war tariffs against European wine and spirits, which may have an adverse impact on CA due to the lower penetration of cork in closures outside Europe, has been "helpful", though we are convinced it has been and remains overrated. However, the company's excellent ESG profile, with very tight Corporate Governance standards in place, its Social Responsibility second-to-none in Portugal (e.g. its Forestry Intervention Program to preserve the cork oak forests), and it's even negative CO2 footprint (cork oaks are a natural CO2 retainer and each cork stopper retains up to 112g of CO2), have been greatly underappreciated to date. In fact, thanks to CA's uniquely favorable carbon footprint (underpinned by its zero-waste approach and strong commitment to the circular economy), almost fully offsetting the carbon footprint of the glass bottle, the total packaging of glass-bottled wine/spirits becomes almost fully carbon neutral. Consequently, we regard CA shares as a highly attractive ESG investment, too.

A consolidated portfolio view

For better transparency, we consolidate our portfolio holdings into a notional combined entity allowing us to better illustrate to investors the economics of an average company in the portfolio. Our 'average company' looks like the following:

Table 1: Blackwall 'average company' portfolio example

Long Investments:
Typical Company Economics

Financials* (EUR m)	2017	2018	2019E[1]	2020E[1]
Sales	4,137	4,293	4,402	4,541
Gross Profit	1,875	1,955	2,025	2,090
EBIT	460	551	591	627
Net Income	295	332	363	400
FCF	237	182	204	239
Net Financial Debt	431	584	498	397

Valuation Ratios*	2017	2018	2019E[1]	2020E[1]
P/E	14.3	24.4	19.9	16.5
P/BV	1.9	3.6	3.1	2.5
EV/EBIT	11.3	17.6	14.3	11.9
Net Debt/EBITDA	0.6	0.7	0.6	0.4
Dividend Yield	2.2%	2.6%	2.8%	3.1%
ROE	17.6%	21.0%	22.0%	23.4%
ROCE	9.0%	9.7%	10.9%	12.2%

* Source: Bloomberg, Blackwall Capital
[1] Note there can be no assurance that these estimates will be achieved

Our investment philosophy is to invest in great companies with a sustainable and superior economic return at attractive valuations, with midcaps being our sweet spot.

Margins: The average company is showing a gross margin of **46.0%**, an EBIT margin of **13.4%** and an FCF margin of **4.6%** (all 2019E), demonstrating strong business models.

EBIT growth: We expect the average company to grow EBIT in the magnitude of around 6-7% p.a. in 2019E and 2020E based on conservative estimates. Furthermore, some of our key holdings show profiles of growth accelerating in the years ahead, benefiting from multi-year restructuring programs and/or structural growth drivers. This allows for additional resilience against any economic downturn.

Leverage: Most of our companies are operating with low net debt positions (some are net cash), thus posting an average net debt/EBITDA of just **0.6x**. At times of rising corporate interest rates, this might provide strategic optionality while others are constraint.

Valuation: In terms of valuation, we use various metrics, with our preferred ratio being EV/EBIT. Our average portfolio trades at **14.3x** for 2019E and **11.9x** for 2020E.

In summary, we argue that the companies invested are attractively valued with a solid growth profile and low leverage.

Best regards,

Thomas Karlovits

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